The Bankers’ Paradox

The Political Economy of Macroprudential Regulaion

Andrew Baker

What is macroprudential and where did it come from?

- Macroprudential ideational shift cemented by the work of the G20 and FSF in 2009
- A set of ideas developed by the central banking community (broadly construed) emphasising procyclicality and financial instability caused by financial and credit cycles – a prominent role for the **LSE** (policy makers name the LSE).
- An emerging set of technical price and quantity instruments for curbing financial excess – a technocratic control project
- Ideational shift took the form of an insiders' coup d'etat – pushed by insider subversives
- Macroprudential – a central banking project, designed by central banks empowering central banks

Types of Macroprudential Governance

- **<u>1. Type 1 –surveillance and monitoring</u>** - stress testing institutions, how disturbance in the real economy would impact on financial institutions and stability – still micro ? (United States)
- **<u>2. Type 2 – Countercyclical interventions to enhance resilience</u>** how financial excess impacts on the real economy, need to curb procyclicality and financial cycles (United Kingdom)
- **<u>3. Type 3 – radical reformation</u>** – hypothetical project that contributes to restructures the relationship with the real economy – 'making finance the servant not the master.'

Macroprudential is inherently paradoxical

- **Paradox 1** –Recognition of **fallacies of composition** necessitating macro steering
- **Paradox 2** – **The 'paradox of financial instability,'** (BIS) risks are borne in periods of stability, system most vulnerable when it appears safest
- **Paradox 3** –**The politically problematic nature of countercyclicality** – action most required when there is least political and social appetite
- **Paradox 4** – **The paradox of technocratic authority** macroprudential's defining characteristic and great strength, is also its principal weakness - a legitimacy dilemma - **The bankers' paradox.**

Dissecting Paradox 4

- Institutional solution to paradox three –independent central banks counter time inconsistent preferences of the public at large due to greater institutional memory
- This also implies that public support for financial stability objectives and for MPP is likely to decline over time
- MPP policy has the potential to be ‘infinitely granular in distributional terms’ – and more politically controversial than monetary policy
- Previous attempts at technocratic price engineering have suffered from legitimacy gaps and creeping public opposition due to failure to build supportive coalitions by distant remote technocrats
- Macroprudential may require a public legitimation strategy that goes beyond financial stability arguments
- Public legitimacy strategies fraught with pitfalls for central bankers

Dissecting Paradox 4 -

- 1. Habits and routines of technocrats – constituency building and questions of social purpose not a normal activity
- 2. Instrumental strategic reluctance – awareness that breach of a limited delegation contract may produce a hostile reaction from politicians
- 3. Relationship with the political process -arms length to politics, an appearance of impartiality threatened if central bankers work too closely with politicians in specifying a public legitimation strategy – an appearance of capture?
- 4. Broad coalition building strategy Getting a critical mass of actors on board required caution. The need to appear non threatening has inhibited boldness – the characteristics of the 'insider subversive' (Mahoney and Thelen, 2010). Esteem in central banking is a function of technical expertise, might be eroded if the question of what MPP can do for the public is pursued?